What should one be doing with commodities in your portfolio now?

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Considering the weaponisation of commodities that has happened with the Ukraine-Russia war, a question that is now often coming to us from investors is about how they should be approaching commodity-related investments in their portfolio now.

Where are we today?

If one looks at broader commodity indices like the S&P GSCI which consists of energy, industrial and precious metals, agricultural and livestock, it is up by more than 40 percent in rupee terms on a year-to-date (YTD) basis, which has mainly been led by energy prices and agricultural commodities The reason for the surge in oil and agricultural commodities prices is, of course, largely the disruption caused by Russia-Ukraine conflict. On the other hand, if you look at industrial metal prices, they are down by about 12 percent in rupee terms YTD, after having surged by about 35 percent last year. The prices of industrial metals including steel have softened on the back of global slowdown concerns that are emerging and signalled by various indicators over the past few months.

However, the broader GSCI has declined by about 12 percent over the past one month on demand slowdown concerns in energy and softness in agricultural commodities with supplies gradually getting back to normal. Over the same period, industrial metals tracked by the London Metals Exchange Index are down by around 17 percent in rupee terms. Thus, slowing growth momentum and fears of a recession are the key reasons behind softness in commodity prices. The Nifty Commodities index, which tracks the performance of a diversified portfolio of companies representing the commodities segment that includes sectors such as oil, petroleum products, cement, power, chemical, sugar, metals, and mining, etc., is down by about 8 percent YTD, after the nearly 50 percent jump in 2021. Over the past month, the index has lost around 6 percent against the 1.5 percent fall in the Nifty. The above suggests that thus far, Indian commodities businesses have been less volatile compared to global peers.

To build commodities exposure, one can either invest through mutual funds or exchange-traded funds (ETFs) that invest in companies involved in respective commodity businesses or by building exposure to mutual funds or ETFs tracking the performance of a commodities index. However, in India, we have a dearth of the latter type of funds or ETFs and you may need to use the LRS (liberalised remittance scheme) route. Thus, the most practical way for most investors to invest would be through funds investing in equities of commodities businesses in India. Most domestic funds have exposure to the basic materials, metals, and mining, energy, and chemicals sectors. Some invest in both domestic and international equities of commodity businesses.

Funds investing in the shares of commodities businesses are much more volatile than funds tracking the price performance of the respective commodity index. So you need to look carefully at your risk tolerance before investing.

Should one be concentrated or diversified?

Commodities tend to be very volatile, as these are affected by economic cycles, demand and supply mismatches, and by geopolitical factors. Therefore, a broader commodities exposure may not be suitable in the current environment unless you have higher risk tolerance. However, commodities like rare earth including lithium may be looked at from a longer-term perspective as these are beneficiaries of a transition to renewable energy, electric vehicles, etc., and demand-supply dynamics would also favour such investments because the available supply resources are not enough to cope with the spurt in demand that is likely to come due to this transition exercise. Clearly, one has to be very selective while taking commodity exposure in the current environment.

We have a few options of investing in silver as well and there has been a case made out for increased industrial use of silver going ahead, but looking at the past data we don't recommend silver exposure. Over the past years, silver has remained almost flat with similar volatility of about 1.5 times that of global equity indices. Therefore, looking at the high risk and very low reward nature of silver, we would recommend staying away, unless someone is able to time the entry and exit well.

Gold may not be the most desirable investment to have, especially in a rising interest rate/real interest rate environment, and has not been a perfect inflation hedge, but it works well in the case of black swan events and in situations where the rupee weakens against the dollar. Therefore, one can consider having 5-10 percent exposure as a portfolio hedge.

How can you build commodity exposure in your asset allocation strategy?

Commodities are a highly cyclical play and, therefore, tend to be much more volatile than the broader equity indices. Hence, entry into and exit from commodities themes become very important, as a long spell of severe underperformance has been observed in the past in commodities indices followed by sharp outperformance. If we look at the past 10 years' performance, the Nifty Commodities has underperformed the Nifty 50 by over 4 percentage points whereas volatility in the performance has been much higher than the broader equity indices.

Additionally, over the past 10 years, the Nifty Commodities has had a very high degree of correlation (around 0.86) with the broader Nifty 50 and, therefore, it does not provide any diversification benefit and behaves more like equities than most commodities except gold.

Therefore, commodities are a high-risk, low-reward game for investors, unless entry and exits are timed well. Therefore, build some gold into your asset allocation and consider some commodities that are structurally important over the long term to add to your portfolio, provided you can deal with the high intermittent volatility

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